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International Economic & Energy Weekly

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International Economic & Energy Weekly

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Perspective

USSR: Oil Export Difficulties Grow

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Declining oil production in the USSR apparently is preventing the Soviets from sustaining oil exports to the West. Soviet hard currency earnings from oil sales could decline substantially in 1985—possibly by as much as $3-4 billion, or over 10 percent of total hard currency export earnings. There are few signs that deliveries to Eastern Europe will be cut this year. If the Soviets continue to insulate Eastern Europe from oil disruptions, such a policy would be in stark contrast with the way the USSR handled a tight hard currency situation in 1981-82, when it eventually diverted oil deliveries from Eastern Europe to the West. 25X1

Moscow has shown little serious concern about its hard currency situation, and we believe that the USSR is in a good position financially to handle the sharp decline in oil export earnings for the balance of 1985. If oil export earnings remain depressed, however, Moscow probably will soon be forced to take more active measures, such as substantially increased borrowing, import cutbacks, and selling more gold. 25X1

For the longer term, a continued decline in oil output—and reduced prospects for oil exports—will pose some difficult choices for the Soviet leadership:

- There is little room for increased diversions of oil from the domestic economy to boost exports to the West, a maneuver the Soviets have used in recent years to sustain hard currency earnings. Some slight savings from energy conservation and substitution programs will probably be realized, but the prospect for widespread savings is not bright. Thus, any major cutbacks in domestic oil allocation are likely to result in disruptive bottlenecks that would threaten Gorbachev's modernization program and perhaps cost him some political setback.

- Substantial cutbacks to Eastern Europe would result in serious economic difficulty to these economies. Moscow will have to weigh carefully the attendant risk of economic instability and increased political tensions in the region that could stem from such cutbacks.

- The Soviets will need to continue importing sufficient quantities of grain and feedstuffs for the livestock program, and obtain the necessary industrial materials to prevent production bottlenecks. Increased imports of Western machinery also would seem necessary if Gorbachev's industrial renovation targets are to be met.

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General Secretary Gorbachev recently visited the West Siberian oil and gas region almost certainly to get a hands-on feel for the problem before finalizing investment choices for the next five-year plan. [redacted] 25X1

Under these conditions, Moscow probably has little alternative but to accept some continuing decline in its oil exports to the West, while trying to squeeze whatever savings it can from the domestic economy and Eastern Europe. In our judgment, the Soviets will continue to import essential agricultural and industrial goods, and will have sufficient earnings to purchase Western machinery and technology that have the highest priority. Reduced hard currency availability, however, could affect other planned imports of Western equipment at a time when the Soviet demand for such goods is likely to increase as a result of Gorbachev's modernization program. [redacted] 25X1

[redacted] 25X1

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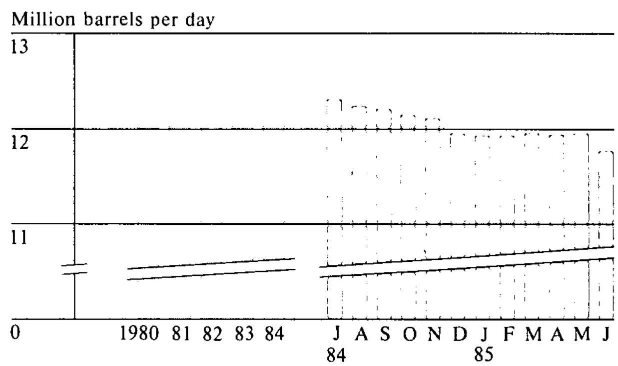
USSR: Implications of Reduced Oil Exports 25X1

Declining oil production is apparently preventing Moscow from maintaining the level of its oil exports to the West. Combined with declining world oil prices, these export losses could cut Soviet hard currency earnings this year by as much as $3-4 billion—representing perhaps 10 percent of total hard currency earnings. So far, Moscow has shown little concern over the export losses, and we believe its financial position will allow it to handle the hard currency losses for the balance of the year. For the longer term, a continued decline in oil output—and the resulting impact on oil exports—will pose some difficult choices for the leadership. Hard currency imports of agricultural products, needed industrial materials, and equipment and technology for priority projects will probably be met, but cuts in other equipment purchases could set back General Secretary Gorbachev's goals for industrial modernization. Diversion of oil exports from Eastern Europe—not evident thus far—would run the risk of hurting their fragile economies and fomenting political unrest in the region.

USSR: Oil Production, 1980-85



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Production Problems Grow

Soviet domestic oil output fell last year—by about 100,000 barrels per day (b/d)—the first time since World War II. On the basis of the oil industry's recent performance, including 14 months of declining output, we judge that production for 1985 will fall by over 300,000 b/d, or by about 3 percent from last year's level.

Moscow is becoming increasingly concerned about its oil prospects. Major steps taken by the leadership to prevent declines in oil output have been to no avail. Last year, Moscow increased substantially investment in oil production, and earlier this year it overhauled the management of the oil sector. In early August, the Politburo decided on a 60-percent increase in construction and assembly work for the West Siberian oil and gas complex in the 1986-90 period. While such measures offer some prospect of slowing the longer term decline in output, they can do little to improve oil output in the next year or two. 25X1

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Reduction in Oil Exports

The West. Soviet oil exports to the West declined by about 40 percent during the first quarter this year compared with the same period in 1984. This was largely due to the harsh winter, which hampered oil production and sharply increased domestic oil consumption. Although few data are available, oil exports apparently rebounded during the second quarter—but not enough to offset the earlier declines 25X1

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Traditionally, the Soviets have substantially accelerated oil exports in the latter months of the year to offset low first-quarter deliveries. According to Western journals with excellent contacts in the energy markets, however, oil traders expect the USSR to cut contract deliveries of oil by between one-third and one-half for an indefinite period beginning as early as September. These cuts suggest that Moscow seriously underestimated the difficulty of turning around the slide in oil production that was evident in late 1984. The Soviet State Planning Committee (GOSPLAN) annually allocates approximate quantities for export to the West. These allocations, in turn, provide the basis for the spate of oil-export contract signings at the beginning of each year. The Soviets have not made an official announcement, and similar press "warnings" sometimes have not been completely borne out in the past. In addition, the Soviet oil export agency recently denied that oil deliveries to the West would decline later this year. Nevertheless, in our judgment, the recent events are unusual:

- The Soviets generally provide only short notice on reductions or cancellations in contract deliveries. This time, they reportedly informed some customers several weeks ago, which suggests that the export difficulties may be substantial.

- When the USSR has claimed force majeure [1] in the past, the declarations were usually accompanied by statements that the disruptions in deliveries will be temporary or made up later. Such qualifications are notably absent this time around. [redacted]

Cutbacks are already taking place. Some customers of Soviet oil reported in the Western press that gasoil deliveries to Western Europe were reduced in August. Finnish oil customers report that Soviet crude oil deliveries are down by over 20 percent of contracted amounts so far this year, and expect a shortfall of about 30 percent by yearend. In addition, in the spot market—where the USSR makes roughly half of its sales to the West—prices for Soviet oil in recent weeks have risen faster than the market as a whole. Such movements in prices in the past have preceded a substantial decline in Soviet oil sales. [redacted] 25X1

To our knowledge, the Soviets have not tried to boost oil imports from the Middle East for reexport to the West. During the first few months of the year, the reexports averaged about 300,000 b/d, about the same level for all of last year. The Soviets in recent years have been able to increase oil deliveries from OPEC—particularly from Libya and Iraq in payment for arms purchases—as a way of increasing its overall exports to the West. [redacted] 25X1

Eastern Europe. Less information is available on Soviet oil exports to Eastern Europe, but there are only indications of some sporadic and small-scale cutbacks to Yugoslavia and Bulgaria. [redacted] 25X1

Nevertheless, in our judgment, Moscow is doing its best to sustain oil deliveries to the region. The Soviets almost certainly would not make any substantial cutbacks in midyear, as this would be extremely disruptive on any centrally planned economy. Rather, any reduction in such deliveries—as was the case in 1982—would be made at the beginning of the following year, in concert with setting the overall annual economic plan. The 25X1 absence of grumbling from the East Europeans suggest that reductions in deliveries to the region are only marginal, and that no Soviet announcement has been made of a larger, more general cutback for next year. [redacted] 25X1

Implications for Hard Currency Earnings

Near Term. The expected decline in the volume of oil sold to the West, combined with lower world oil

[1] Force majeure is a contract clause that exempts a party from fulfilling a contract due to extraordinary circumstances. [redacted] 25X1

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prices could lead to a reduction in hard currency earnings of about $3-4 billion for 1985 as a whole. This would be a drop of 20 to 25 percent in earnings from oil sales, and could result in a decline of more than 10 percent in the USSR's total hard currency earnings.

Moscow cannot compensate for this drop by expanding other exports. Soviet earnings from natural gas sales to Western Europe are not expected to rise substantially this year. On average, Soviet gas prices have fallen somewhat, and the USSR has allowed at least one nation to postpone increases in purchases of Soviet gas. Other exports—including sales of metals, machinery, and weapons—face limited developed country or LDC demand and, in some cases, constrained domestic availability.

The USSR is probably in a fairly good financial position to cope with this year's oil export decline. At the end of March Soviet assets in Western banks stood at a comfortable $8.8 billion. So far, Moscow has shown few signs of serious concern about the need to compensate for a major drop in oil earnings:

- Gold sales appear to to be up only slightly over the relatively low levels in 1984.
- While Moscow has borrowed close to $1 billion from the West this year, most of this money apparently has been used to pay off earlier, higher-priced loans.
- The Soviets turned down a French offer of approximately $500 million in credits for Astrakhan' and Tengiz energy development contracts, which were signed this spring.

The expected erosion of its oil export earnings during the balance of 1985, however, could force Moscow to take necessary adjustment measures in the near future. Options exercised in the past include increases in net borrowing, cutbacks in imports, and larger gold sales. In response to a hard currency bind that developed in the first half of 1981, Moscow cut back hard currency allocations to the foreign-trade organizations in late 1981 and early 1982, causing delays in purchases and payments. In addition, the Soviets substantially increased short-term borrowing (mainly for grain purchases) and gold sales. 25X1

On balance, we believe that the USSR can satisfy most, if not all, of its import requirements from the West in 1985. Moscow will be helped this year by a better domestic grain crop that will substantially reduce grain import requirements in the latter half of the year. Moreover, abundant world grain supplies should result in a buyer's market cutting Soviet import costs. In addition, overall imports of Western industrial goods during the first quarter were lower than during the comparable period in 1984. It is not yet clear whether such imports have remained at reduced levels since then. While Soviet orders for machinery and equipment are up sharply during the first half of the year compared with last year, actual deliveries will not begin to rise until 1986 or beyond, given the usual lags in implementing contracts for large projects. Moreover, many of the deals are financed by long-term credits.

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Longer Term. Beginning in the next year or so, the Soviets will likely have to deal with steadily declining export earnings from oil: 25X1

- Domestic oil output probably will continue to slide despite substantial increases in investment in the oil industry. Although the oil industry management has been overhauled, prospects for a turnaround in output are poor.

- There is little prospect for a reversal in the decline in world oil prices until the late 1980s.

- Opportunities for boosting arms sales to OPEC nations—the traditional source for increased oil imports—are limited by the ability of these nations to absorb more arms. 25X1

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Moscow will be hard pressed to compensate for the production decline through reduced domestic consumption. It has been trying to reduce the economy's use of oil for several years, primarily through energy conservation and programs for switching to the use of gas instead of oil in industry. There have been few signs however, that the USSR has, in fact, reduced its oil use. The Soviet press has been mum on successes in this area, suggesting that progress is dragging despite the leadership's emphasis on conservation. In addition, our analysis of the electric power industry—the main target of the gas-for-oil substitution programs—indicates that the oil "saved" at some power plants has been consumed anyway in offsetting major shortfalls in the supply of coal to other power plants and in producing above-plan amounts of electricity.

Prospects for limiting demand during the next several years also are not bright. Gorbachev's program for retooling and installing more energy efficient equipment promises substantial savings, but only in the long run and after considerable expense. Over the next several years, the modernization program, vigorously pursued, will itself consume large quantities of fuel. Indeed, given Gorbachev's stated objectives, the mix of industrial output is likely to become more rather than less energy intensive.

Implications for Eastern Europe

Moscow's allies would have considerable difficulty coping with a cutback in Soviet oil deliveries. Most of the countries in the region—plagued by sluggish export growth, large debt service obligations, and uncertain borrowing prospects—do not have enough hard currency to purchase a substantial portion of their oil requirements on the international markets. Moreover, securing more oil through barter arrangements has been made more difficult because of a reluctance of Third World countries to increase such deals.

Moscow repeatedly has told its allies that deliveries will not be cut in 1986-90. It made a similar promise in 1980, however, for the 1981-85 period, but cut deliveries anyway in 1982 when it needed to increase hard currency earnings. In the aggregate, oil shipments to the region have not increased since then.

The East Europeans survived the 1982 cutbacks without much difficulty because the region was reexporting some Soviet oil for hard currency. Cuts during 1986-90 would be much more troublesome as they likely would come out allocations for the domestic economies—at a time when Moscow will be putting more pressure on East Europe to increase production and delivery of energy-intensive goods (i.e. machinery and equipment). Reduced oil consumption in the region would affect economic productivity and growth and, in turn, increase the likelihood of political instability in Eastern Europe and increased public resentment toward the Soviet Union. 25X1 25X1

Implications for Trade With the West

Moscow probably has little alternative but to accept some continuing decline in its oil exports to the West, while trying to squeeze whatever savings it can from the domestic economy and Eastern Europe. Faced with prospects for substantially reduced hard currency earnings, the Soviet leadership may be hard pressed to satisfy the entire range of import goals in the coming years. 25X1 We believe, however, that the Soviets will continue to import sufficient quantities of grain and feedstuffs to keep the livestock program on track and obtain the industrial materials needed to reduce production bottlenecks. 25X1

The reduced availability of hard currency will probably affect imports of Western machinery and equipment the most. Barring a series of harvest failures and/or an unexpectedly rapid decline in oil production, Moscow should be able to earn enough hard currency through 1990 to purchase Western equipment that has the highest priority—equipment needed to develop oil and gas reserves at 25X1 Astrakhan' and Tengiz, for example. Any cutback in imports of other Western machinery and technology would be occurring at a time when Soviet demand for such goods is increasing as a result of

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Gorbachev's modernization program. A less conservative borrowing policy, however, could allow Moscow greater leeway in setting the level of these imports. 25X1

Changes in Soviet purchasing strategy may provide early indication of how the Soviets are assessing their prospects for oil production and hard currency exports. Specific indicators might include:

- Scaling back, stalling, and/or canceling project negotiations now underway.
- Insistence on countertrade arrangements for all but the highest priority purchases.
- Greater concentration on domestic projects oriented toward supplying the export market when negotiating purchases from the West. 25X1

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South Africa: Financial Difficulties [redacted] 25X1

Pretoria's recent announcement of a four-month suspension of repayment of most foreign debt principal will undermine investor confidence already shaken by political uncertainties. The South African rand is likely to remain weak at least until the domestic unrest subsides. Barring a collapse of the rand, Pretoria will probably weather the current liquidity crunch through rescheduling and some new European bank lending—albeit at premium rates. Nonetheless, until investor confidence returns and the political situation stabilizes, the South African economy will remain vulnerable. [redacted]

Developing Debt Crunch

Pretoria usually has practiced conservative foreign debt management to assure continued access to credits despite foreign criticism of its racial policies. On several occasions the government has clamped down hard on economic growth to reduce import demand. In 1983, however, misplaced optimism about crop yields and gold price trends led Pretoria to allow a rapid economic expansion funded largely by short-term overseas borrowing. Much of this is owed to US commercial banks, which now hold about one-fourth of South Africa's $12 billion short-term debt, according to US Federal Reserve data. [redacted]

In August 1984, Pretoria belatedly imposed economic austerity measures, which included restrictions on consumer borrowing and a 25-percent prime lending rate. The measures brought the current account back into surplus but caused the economy to slump rapidly. Real GDP fell by 2.5 percent between second quarter 1984 and second quarter 1985. [redacted]

The current account surplus has not offset a drain of more than $2 billion in capital over the last 18 months. Much of the early capital outflow went to reduce foreign indebtedness. More recently, growing international nervousness over South African political and economic uncertainties led foreign banks to trim their credit lines to South Africa. Capital flight apparently has accelerated as a few foreign firms sold South African subsidiaries and some residents sent money abroad for possible future emigration. [redacted] 25X1

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The credit squeeze began gradually with reduced offerings by US banks but spread to some West European lenders after the government declared a state of emergency in July 1985. According to US Embassy sources and recent IMF data, South Africa only has about $2.5 billion in foreign exchange and gold reserves[1] and another $1 billion in anticipated current account surpluses over the next six months. Against this, the country was facing some $7 billion in debt obligations through next March, the bulk of which probably would have been rolled over in the normal course of events. [redacted] 25X1

Rand on the Run

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As foreign borrowing grew, the rand depreciated. From an average of $1.30 in the first quarter of 1980, the rand sank to $0.49 in the first quarter of 1985. Reduced direct controls over exchange rates

[1] In this figure, South African gold reserves are valued at near-market prices. [redacted] 25X1

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allowed the rand to slide downward with the world price of gold—the source of nearly 50 percent of South Africa's export earnings. [redacted]

More recently, the rand has become even more volatile as South African companies have scrambled periodically to obtain foreign currency for future transactions in the self-fulfilling expectation of further declines in the rand. In particular, political events during the past three months, such as the declaration of a state of emergency and the arrest late last month of noted antigovernment activist Alan Boesak, have triggered near-panic runs on the rand. [redacted]

In response to a sudden drop in the value of the rand and an acceleration of withdrawal of foreign credit lines by some banks, Pretoria suspended trading on South African foreign currency and stock markets for four days, followed by an announcement of a four-month moratorium on most principal repayments on foreign debts. Interest payments, however, are to continue. [redacted]

Still at Risk

Although pressures on the rand have been reduced by the controls on capital, dramatic political events in South Africa and foreign moves toward new economic sanctions are still likely to sharply affect the exchange rate over the near term. Moreover, the relatively small amount of rand traded—and local business concern to cover future transactions—will continue to make the currency potentially quite volatile. [redacted]

The South African central bank has unwittingly helped to focus foreign investor and creditor attention on the rand by announcing central bank intentions to support the currency through market intervention. The rand is seen by many observers as an index of investor confidence. If the central bank cannot stabilize the rand, investors will be convinced that the debt moratorium has failed to resolve the liquidity crunch. A further sharp decline in the rand would add to creditor uneasiness and likely complicate negotiations to reschedule the debt. [redacted]

South Africa's commercial bank creditors probably see little choice but to wait for Pretoria to initiate negotiations to reschedule the short-term debt. 25X1
[redacted] some major US and West European banks remain confident of South Africa's willingness and ability to repay [redacted] These banks likely attribute the debt crunch not to South African economic problems, but to concurrent refusals by many smaller banks to renew expiring credits. [redacted]

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Bankers may have found some reassurance in Reserve Bank Governor de Kock's assertions that South Africa would ask for neither new money nor renewal of expiring credit lines at rescheduling negotiations, but only for a slowdown of the pace at which the country must repay expiring loans. South Africa's promise to maintain full interest payments also may have gained patience from bankers, as banks can avert loan loss provisions as long as interest payments continue. We estimate South Africa's interest obligations are about $100 million per month, which would be covered by the $140 million per month South Africa claims it has available for debt service. This amount falls far short of principal repayments currently being sought by banks, however [redacted]

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Even though trade-related payments are exempt from the moratorium, we see potential for South Africa's trade activities to be complicated by the debt standstill. In response to uncertain prospects for repayment, banks could refuse to negotiate South African letters of credit, thus delaying or possibly preventing shipment of imports. In a similar response, South Africa's industrial country trade partners have begun to curtail export credit guarantees. According to US Embassy and press

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reports, Japan and the Netherlands each have announced restrictions on guarantees since the debt moratorium was declared. [redacted]

Options for South Africa

Unless creditor confidence is undermined by a collapse of the rand, South Africa probably will be able to reach agreement with foreign banks to solve its immediate debt problem. [redacted] the major international banks probably would accept a rescheduling of short-term debt over one year. Moreover, British financial officials may privately advise UK banks to cooperate with a rescheduling, according to US Embassy reporting. In addition, early indications are that some West European banks are prepared to offer new loans—although possibly at substantial premiums—to fill the financial gaps left by other banks. Some banks are charging interest rates as high as 4 percentage points above LIBOR for stopgap loans to South Africa, according to US Embassy reporting. In contrast, interest rates for the key Latin American debtor countries currently are less than 2 percentage points above LIBOR. [redacted]

Another option for Pretoria would be to sell some of its gold holdings to help meet debt repayments. Officially, South Africa has $2 billion worth of gold in reserve, but persistent rumors suggest actual reserves are much greater. Because large-scale gold sales on the open market would cause the gold price to drop, any sale of reserves almost certainly would be privately arranged with a few select buyers. As long as further economic sanctions against South Africa remain possible, however, Pretoria probably will be wary of drawing on its reserve cushion. In a costly, high-risk variation that would leave reserves intact, South Africa also could try to mortgage future gold production in return for immediate cash. [redacted]

[redacted]

[redacted] unless a windfall increase in the gold price significantly boosted the country's export earnings, South Africa probably would face years of stagnation, high interest rates, limited investment, and double-digit inflation. [redacted]

If credit lines evaporated, Pretoria might decide to renounce its debt altogether, and brace itself for likely new economic sanctions. The country has adequate stockpiles of key resources and spare industrial capacity to allow the economy to plod along for several years. Although this "siege economy" option has been advocated by some rightwing South Africans, it is unlikely to be adopted except under extreme duress. Nevertheless, Pretoria probably will use the threat of indefinitely delaying repayment of debt obligations to particular banks or countries if necessary to obtain bank cooperation in debt restructuring. [redacted]

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World Automakers: Financial Performance and Future Competitiveness 25X1

The financial positions of the world's major automakers have changed dramatically over the past decade. The large Japanese auto firms have garnered great financial strength that will secure their strong competitive position through 1990. At the other extreme, Western Europe's volume producers are in dire financial straits. Five years of losses and mounting indebtedness have generated deep financial strains, particularly for the large French automakers—Renault and Peugeot. Although US producers have rebounded with record profits, they remain vulnerable to market downturns and Japanese competition because of relative inefficiency in small-car production, dependence on sales of larger cars for profits, and high average labor costs. 25X1

A Glaring Contrast

The financial strength of Japan's major automakers has increased steadily. With a high quality, fuel efficient product line and an aggressive marketing strategy, Japanese firms have been able to increase or maintain unit sales during both market downturns of the past decade (1974-75 and 1980-81). These high sales volumes, in conjunction with strategies to increase labor productivity and reduce manufacturing costs, have provided steady returns on sales and assets over the past decade. This, in turn, has enabled producers such as Toyota to reduce long-term debt, further reducing costs. The combination of liquid resources and low debt has shielded large Japanese automakers from the kind of financial pressures faced by their US and West European counterparts. 25X1

In contrast, the financial pressure on Western Europe's automakers has intensified. Costly sales battles in their home markets and the struggle to keep abreast of rapidly advancing technological developments have created a large financial burden

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VRA and Japanese Profitability

The profitability of Japanese automakers depends heavily on exports to the US market. Although the voluntary restraint agreement (VRA) halted the rapidly growing penetration of Japanese autos into the US market, the yen value of Japanese passenger car exports to the United States increased nearly 90 percent from 1980 through 1984. The increase was accounted for by:

- *Rising automobile prices in the United States.*
- *A shift by the Japanese toward exports of larger, higher priced cars and the addition of high-margin options.*
- *The appreciation of the dollar.* 25X1

We estimate that the share of total Japanese motor vehicle profits coming from the US market jumped from about 20 percent in 1980 to at least 50 percent in 1984. the estimates of some Japanese economists indicate that the share may have been as high as 80 percent. 25X1

In contrast to exports, sales in the Japanese home market have yielded meager profits. Because the VRA limited exports to the United States, the nine Japanese automakers, particularly the smaller companies with proportionately small quotas, have been engaged in a domestic price war to maintain the volume necessary to achieve economies of scale. This fierce competition has kept domestic profits in Japan near the break-even point. According to Japanese auto analysts, Toyota is the only company able to make a domestic profit because of its more efficient production and dealer network. 25X1

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for nearly every volume producer. Chronic overcapacity prevented firms from regaining profitability. As a result, automakers have cut dividends, reduced working capital, liquidated assets, and turned increasingly to long-term debt to finance investments in new products and technologies. Although sales for several European firms have begun to rebound, the losses and high debt burdens have severely weakened their long-term financial strength. [redacted] 25X1

West European governments have kept their automakers afloat and maintained employment levels through substantial financial support in the form of tax breaks, low-interest loans, and increased equity participation. Faced with a growing unemployment problem, governments have thwarted needed labor cuts in an industry that is typically the largest employer. Furthermore, companies dependent upon government support have difficulty planning long-term strategies because of uncertainty over levels of future funding. [redacted]

Domestic Capital Spending

According to recent press reports, Japanese automakers plan to boost domestic capital investment largely to improve manufacturing efficiencies rather than expand capacity. Major expenditures include greater application of advanced robotics, computer-aided design and manufacturing, and flexible manufacturing systems. Overall, industry experts estimate the Japanese will increase productivity 20 percent by the late 1980s by increasing the use of automation. In addition, we believe substantial funds will be allocated for the development of larger cars. [redacted]

West European automakers' investment strategies are aimed at closing the gap with the Japanese on production costs. To this end, Renault and Fiat have each increased their capital spending to about $1 billion per year, and VW is spending nearly twice this level. [redacted] 25X1 current spending is not sufficient for European automakers to regain competitiveness. [redacted] 25X1 European manufacturers need to invest at least $11 billion a year during the rest of the decade to develop new cars, update existing ones, and automate their plants. Because of constrained cash-flow and low profitability, however, the industry's financing shortfall could reach $20 billion by 1990. Not only are banks and equity markets unlikely to provide the necessary funding, but European governments—themselves strapped for cash—are increasingly reluctant to sink more money into the industry. [redacted] 25X1

Foreign Investments

Market access restrictions—both real and potential—as well as a mature domestic market have undoubtedly contributed to the Japanese push to establish foreign production facilities. Heavy reliance on foreign sales—Honda exports nearly 73 percent of total production, Nissan 53 percent, and Toyota 41 percent—makes the Japanese firms extremely vulnerable to these restrictions. Even Toyota, the most reluctant foreign investor, recently announced plans to build large production facilities in both the United States and Canada. [redacted] 25X1

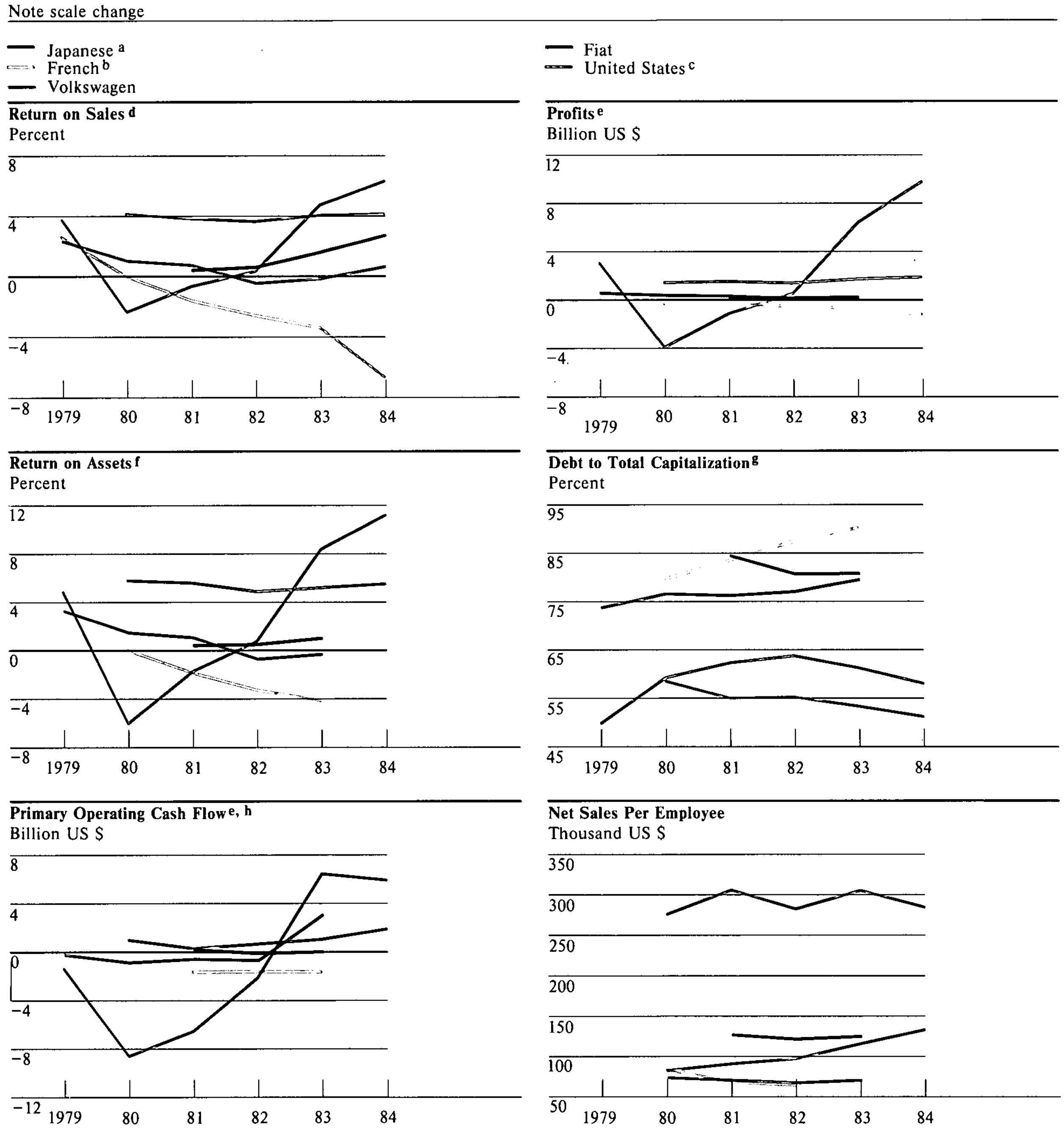
The Japanese have concentrated on building assembly rather than manufacturing plants abroad, thus retaining domestic production of high-value-added components, such as engines and drive trains. This approach keeps domestic auto employment high, maintains economies of scale in Japan's highly automated plants, and gives manufacturers greater control over the price and quality of major components. [redacted] 25X1

At the same time, financial problems have forced European producers, such as Fiat and VW, to pull out of foreign markets. Their weak financial position has not allowed them to maintain expensive overseas facilities, particularly as these markets turn down. [redacted] 25X1

R&D Expenditures

Strong finances have enabled Japanese auto firms to undertake high risk R&D. Although absolute R&D spending by US automakers is much greater than that of their Japanese competitors, the ratio of

World Automakers: Comparative Financial Performance, 1979-84



[a] Weighted average of Toyota and Nissan.
[b] Weighted average of Renault and Peugeot.
[c] Weighted average of GM, Ford, and Chrysler.
[d] Net profits to net sales.
[e] Cumulative totals, not weighted averages.
[f] Net income to total assets.
[g] Total liabilities to total assets.
[h] Net income plus depreciation minus capital spending.

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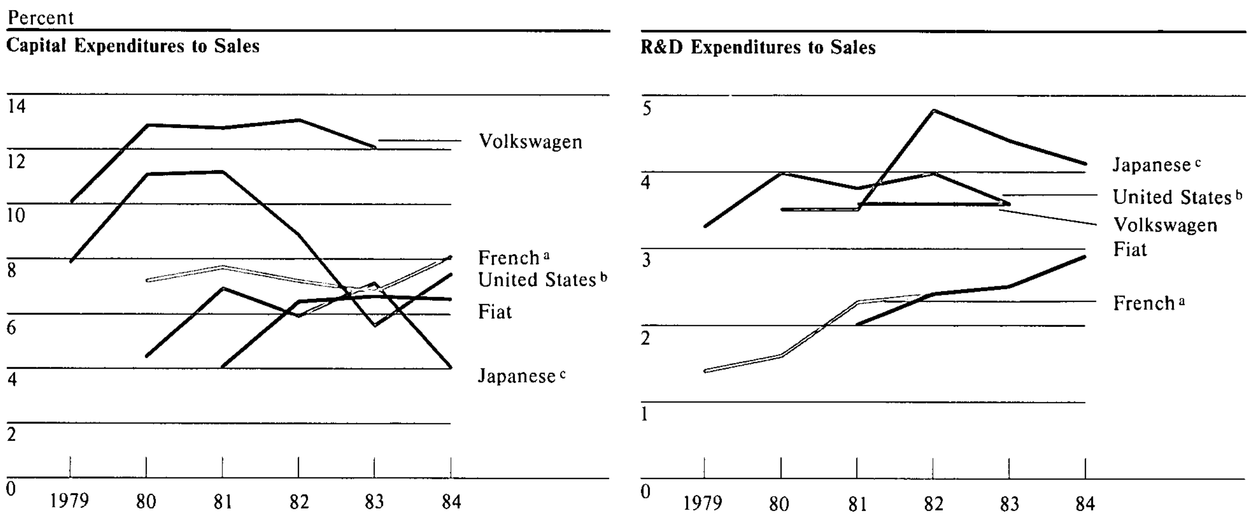
World Automakers: Capital and R&D Expenditures, 1979-84



[a] Weighted average of Renault and Peugeot.
[b] Weighted average of GM, Ford, and Chrysler.
[c] Weighted average of Toyota and Nissan.

[redacted] 25X1

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R&D to sales is comparable or greater for the Japanese.[2] Current R&D expenditures center on further improvements in fuel efficiency through developments in ceramic ignition parts, electronic engine and transmission controls, and improved aerodynamics. Longer term R&D expenditures focus on ceramic diesel engines and composite materials. [redacted] success in these areas would enhance the Japanese competitive position, giving them a multiyear lead by the end of the decade in some commercial applications of fuel efficient and weight-reducing technologies. [redacted]

The increased emphasis on R&D presents competitive problems for European automakers. Small profits and pressures to devote scarce resources to capital investment will prevent them from matching US or Japanese levels of R&D. Except for VW, individual corporate R&D spending for European automakers is on a much lower level—both in absolute and percentage bases. Financial problems have forced Renault to cut R&D by one-third this year. In the long run, we believe European manufacturers will be forced to gain access to new technologies through joint ventures with US and Japanese firms. [redacted] 25X1

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Japan: Growing Competitive Strength

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Underpinned by its financial strength, the competitiveness of Japan's automakers, in our estimation, will grow further. Economic recovery in the United States, coupled with the relaxation of the export restraint and increasing overseas production,

[2] The Japanese figure, however, may be significantly understated because they do not include substantial R&D expenditures of some 250 component suppliers. According to independent studies, the R&D expenditures of Toyota and its affiliates may have reached $1.5 billion last year compared to Toyota's reported $850 million. [redacted] 25X1

should enhance their financial growth and their ability to carry out aggressive strategies. Moreover, the shift to larger, higher profit cars will enable the Japanese automakers to continue amassing large profits from the US market, making some of them, Toyota and Nissan in particular, among the most financially viable companies in the world.

To the extent Japan's automakers are successful in capturing more of the overseas component and subassembly markets, their earning power should grow further. This opportunity is increasingly viable as the Japanese firms build plants in the United States and Europe and as US firms produce smaller cars incorporating components (such as engines) that they cannot economically manufacture. Increased component sales, in turn, will allow Japanese suppliers to achieve economies of scale and further reduce component costs to their parent companies. At the same time, profits by component subsidiaries will reinforce their ability to develop and apply leading-edge product and process technologies.

Europe: Needed Restructuring

Although the West European auto industry must take major actions to reduce costs to restore its financial health, Europe's socioeconomic framework is not conducive to such changes. Structural difficulties in the European auto industry have been compounded by government policies aimed at equalizing the selling prices of cars, reducing exhaust pollutants, and cutting the workweek. Whatever the social benefits of these programs, they add considerably to the industry's financial problems.

Inevitably, capacity and employment will have to be rationalized if the industry is to return to profitability. While national pride and political realities make it almost inconceivable that any of the big European producers will be allowed to fail, most volume producers will be forced to:

- Close their most inefficient plants and layoff workers to reduce costs, despite strong union opposition.
- Reduce their broad range of models and look for market niches that allow a reasonable profit. BL, Fiat, Peugeot, and Renault have already been compelled to specialize in low-end segments of their home markets.
- Outsource major components from lower cost overseas production facilities. Peugeot, Ford, GM, Renault, Fiat, and VW already outsource in a significant way from Spain, and investment in Latin America and Southeast Asia promises even greater cost advantages.
- Enter into cooperative licensing agreements or even mergers. The exchange of technological knowledge and the reduction in manufacturing costs through longer production runs have prompted European competitors to establish joint production of gearboxes, engines, and transmissions. Because of their inability to fund new production facilities and long-term R&D, European linkups with the Japanese and US automakers may also increase.

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Implications for the United States

As Japanese producers continue to expand manufacturing in the United States, the added capacity could place even greater pressures on market share and profitability of US automakers. As the low-cost Japanese producers begin manufacturing and selling automobiles in the area of US strength, they may set low prices, increase market share, and erode the profitability of US firms. As the Japanese secure a higher share of the upmarket, and as European niche producers capture more of the luxury, high-profit end of the US market, the profitability of US producers may be increasingly squeezed, lowering their ability to make future investments.

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Furthermore, while US (and European) automakers were struggling to maintain their domestic markets, Japanese producers were using their financial strength to secure Third World markets. As Japanese firms become established in small but growing third markets—such as the Pacific Basin, China, South America, and India—future entry by US firms may become more difficult. The failure of US automakers to compete in these markets will give the Japanese another uncontested profit source, leaving US firms even more vulnerable at home. Additional linkups between European and Japanese companies would increase the competitive problem for US producers both in Europe and at home.

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The current balance of market shares in Europe is not stable—major changes can be expected unless further government support is forthcoming to aid ailing companies. Such aid, however, will further delay the much needed rationalization of European production capacity, hurting the profitability of US producers in the region. Moreover, as the Japanese circumvent European trade restrictions through foreign investment, overcapacity and price pressures on European and US automakers will continue to increase. Current agreements indicate that the assembly of Japanese cars in Europe will at least triple to 400,000 units by 1990. 25X1

The impact of these trends go far beyond the auto industry. Because of its sheer size, a healthy auto industry has the ability to spur development of a variety of other technologies, often bringing those technologies to market long before they would otherwise be commercialized. Japanese efforts in robotics, advanced materials, and electronics, for example, have been pulled along by applications in their auto industry. Because sales to this sector are so large, technology vendors can gain valuable production experience and achieve economies of scale, which in turn facilitate rapid application of these products in other industries. Automotive applications of advanced composite materials, for example, will likely support the development of special tooling and production experience for applying similar materials in the next generation of military and commercial aircraft. 25X1

United Kingdom: Thatcher Pressured on Unemployment [redacted] 25X1

Prime Minister Thatcher's failure to alleviate Britain's severe unemployment has intensified domestic dissent over her economic policies, despite improvement in most economic indicators. The ruling Tories are split: moderates advocate that the Prime Minister tone down her harsh conservatism and spend more, while rightwingers are wedded to their original course and want, instead, tax cuts and fundamental reductions in the welfare state. [redacted] 25X6 Despite strong pressures to show progress on unemployment, we do not expect the Prime Minister to make any major policy shifts. As a result, the unemployment rate is likely to remain in double digits for several years, and the problem is certain to be the major issue in the next national election, which must be held by June 1988. [redacted]

Economic Progress

Prime Minister Thatcher continues to emphasize the overall improvement the British economy has shown over the past several years:

- Real GDP growth averaged 2.5 percent in 1982-84 and probably will register 3.5 percent this year.
- Inflation dropped from almost 12 percent in 1981 to only 5 percent last year. Despite a recent acceleration, London will probably be able to hold the inflation rate for the year to less than 6 percent.
- Industrial production, which had slumped 12 percent during the 1980-81 recession, has gradually gained momentum since mid-1983 and is projected to grow about 6 percent this year. In addition, business profits rose 20 percent in both 1983 and 1984.
- Britain's trade deficit, which had worsened considerably during the coal strike in 1984, has been declining since May.

Thatcher also can take credit for a number of other economic successes. She quickly resolved the pound sterling crisis earlier this year; weathered the year-long miners' strike that effectively weakened the unions' power in the heavy industry sector; increased government revenues by more than $8 billion from the sale of state-owned industries; and started eliminating excessive redtape to spur productivity and job creation. [redacted] 25X1

Critics Focus on Unemployment

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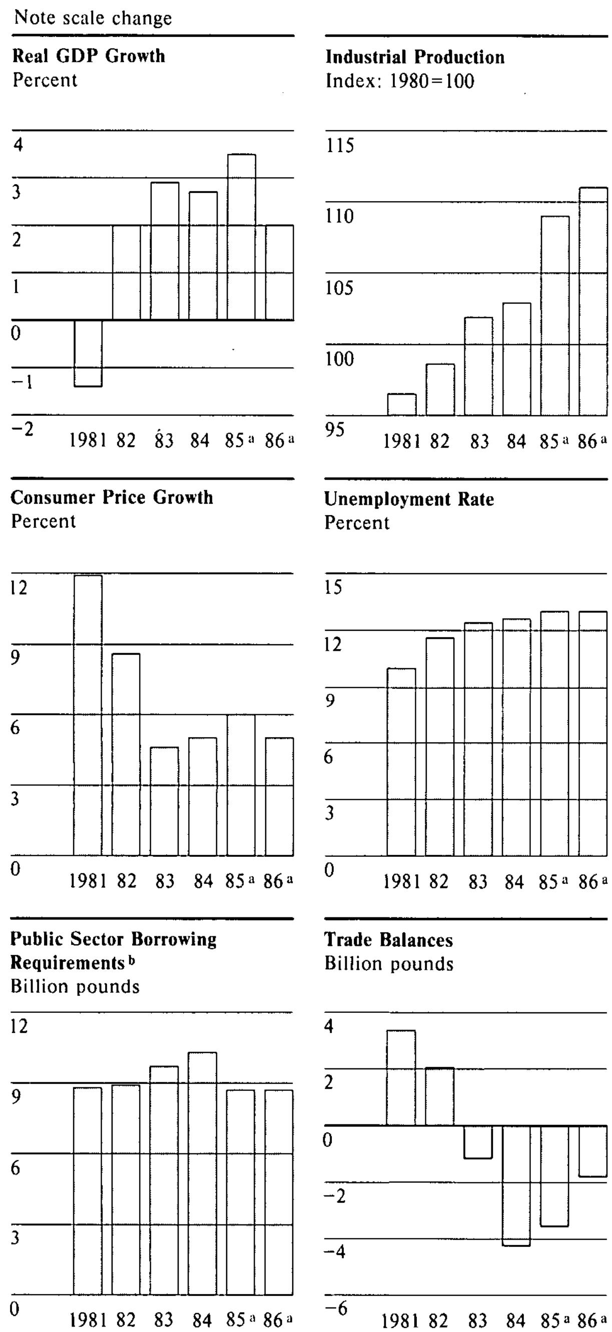
Nonetheless, election results and opinion polls show that all of this good economic news is overshadowed by unemployment. Gallup surveys indicate that 80 percent of the population consider unemployment to be the most urgent problem currently facing Britain. The recovery has not created enough new jobs to compensate for the increasing size of the labor force. Unemployment—5.7 percent in 1979, the year Thatcher took office—hit 13.2 percent in August 1985. The worst hit areas in northern England and Wales are experiencing levels as high as 22 percent. Moreover, the time a worker remains unemployed has lengthened dramatically over the last few years, and now more than 40 percent of the unemployed have been out of work for more than one year. [redacted] 25X1

United Kingdom: Economic Indicators, 1981-86



[a] Forecast.
[b] Data are for financial year beginning 1 April of the year stated.

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Groups of all philosophical and political persuasions—including businessmen, the Trades Union Congress (TUC), Tory moderates, the SDP/Liberal Alliance, the Labor Party, and academics—sharply criticize what they call Thatcher's laissez faire attitude and offer proposals for reducing unemployment. Dissident Tory leaders, concerned about what they describe as "the defeatism over unemployment that has been polluting the political atmosphere of this country," founded a private think tank in May—called the Employment Institute—to recommend solutions. Opposition leaders have scored points by claiming, as one put it, that "today's Tory Party is a government with a policy of deliberate unemployment." 25X1

In a statement of economic priorities released jointly with the TUC in August, the Labor Party promised to make job creation its top priority as soon as it returns to power. Labor Party leaders put the budget cost of unemployment (lost taxes as well as paid benefits) at $25 billion a year. Simulations of our econometric model support Labor's claim. The Labor Party proposes greatly increased spending on infrastructure and job training and wants the government to play a major role in research and development and the management of trade. 25X1

At the same time, the Prime Minister must respond to arguments from her rightwing Tory allies, who remain committed to cutting the role of government in the economy in order to promote private-sector job creation and who say Thatcher must go even further in her drive for major reforms. Various organizations have published figures illustrating that, despite her rhetoric, Thatcher often does not adhere to her tight fiscal and monetary targets. Since 1980, for example, growth in the money stock sterling M3 has substantially overshot the target ranges. Similarly, London exceeded the planned Public Sector Borrowing Requirement (PSBR) by 2 billion pounds in the 1983/84 financial year, and most forecasters strongly doubt the government's ability to meet the 1985/86 target. Rightwing critics point out that total public spending in real terms in the 1984/85 financial year was more than 9 percent greater than in 1979/80 and that spending has gone up in all major areas—defense, education, health, and social services. 25X1

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Thatcher's Response

Thatcher continues to insist that the government cannot attack unemployment directly. She maintains that the government must follow policies aimed at holding down inflation and reducing government spending as a share of GDP in order to provide an economic climate conducive to growth and job creation. She and Chancellor of the Exchequer Lawson dismiss calls for more expansionary fiscal policy, contending it would result in higher inflation, not higher output. Lawson also has rebuffed business demands for an immediate sharp cut in interest rates.

Nonetheless, Thatcher announced a series of job creation measures earlier this summer, including:

- Using state funds to encourage economic development in depressed areas.
- Removing youth from minimum wage controls.
- Eliminating some of the administrative and tax burdens faced by small businesses.
- Doubling the amount of money made available to the National Coal Board for creating jobs in pit closure areas.

London also is touting its plan to reform Britain's generous welfare system as an important effort to reduce unemployment. Thatcher has repeatedly claimed that present welfare programs discourage work and hamper economic recovery. The government is calling for the phasing out of the State Earnings-Related Pension Scheme, a heavily subsidized program created by the Labor government in 1978 to supplement the flat-rate universal pension, and the elimination of payments such as death and maternity grants, for which all citizens are now automatically eligible regardless of income. London wants to encourage the growth of private-sector pension plans and make pensions more flexible to facilitate regional and occupational mobility. Thatcher has promised that savings in public spending would be translated into tax cuts, which in turn would stimulate business, consumer spending, and job creation.

Outlook

We believe Thatcher will not make any major fiscal or monetary policy shifts in the coming budget year. Not only does she firmly believe that her present economic strategy is the correct one, but she also does not want to appear to be wavering or succumbing to criticism. Nonetheless, she is likely to become somewhat more accommodating to complaints from both the left and right. She probably will accept some additional spending for job creation and social and health services to improve her image, provided enough money is still left over to permit limited tax cuts.

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Under this generally steady policy course, however, we believe the chances of unemployment falling significantly in the next few years are slim:

- Demographic trends will continue to place upward pressure on the unemployment rate. The UK Department of Employment recently doubled its projections for the rise in the labor force in the 1985-87 period to 200,000 a year.

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- Most forecasters expect a slowdown in economic growth next year, with output growing by about 2 percent a year in 1986 and 1987.

- Government training programs are often poorly coordinated with industry and reap little benefit. According to press reports, 60 percent of graduates from youth training programs fail to either enter the work force or continue their education.

- Finally, high unit labor costs—which the Thatcher government has blamed for much of the unemployment problem—have failed to come down despite London's attempts to limit the growth of public-sector wages and reduce the national insurance contribution employers must pay for low-paid workers.

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Failure to show progress on the unemployment front by the middle of 1986 would, in our view, badly hurt Thatcher in the next election. Her only hope would be to convince voters that the policies of the opposition parties would be even less successful in creating new jobs and would be detrimental to the overall economy. [redacted]

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Bolivia: Courageous Attempt at Economic Reform [redacted] 25X1

In a major attempt to break the inflationary spiral now reaching the 14,000-percent level, Bolivia's new President Paz Estenssoro has announced a no-nonsense austerity program to put the failing economy back on a firm footing. Faced with his first major challenge, a nationwide strike in opposition to the program, the President has stood firm. Paz Estenssoro has the support of the military high command in countering public unrest, and opposition political parties are withholding criticism. [redacted]

Nonetheless, the government still needs to reform the monetary system and develop a strategy for attracting international financial support. On the basis of Bolivia's lackluster record in sustaining reform, we believe that strict adherence to the austerity package will be necessary to restore international confidence. As austerity cuts living standards, moreover, we expect additional political challenges to the reforms. [redacted]

Tough Stabilization Measures

Paz Estenssoro wants to stem hyperinflation by reducing the public deficit, which equaled 23 percent of GDP in 1984. The program announced on 29 August includes:

- A four-month freeze on public-sector wages and a proposed two-thirds cut in public-sector employment to 100,000 by the end of the year.
- Import restrictions were lifted and a flat 10-percent tax was levied on foreign trade transactions to replace complicated and corruption-prone customs duties.
- A promise to halt subsidies to unprofitable state enterprises.
- A removal of price controls to revive production and reattract goods being diverted to the black market.
- The decontrol of interest rates and reestablishment of dollar-denominated bank accounts to attract investment capital back to the banking system.
- A 93-percent devaluation of the peso to encourage exports.
- Establishment of a biweekly auction of foreign currency to maintain a realistic exchange rate. [redacted] 25X1

The US Embassy reports that the IMF has reacted favorably to the program, which may set the stage for a formal IMF agreement later this year. Until then, however, lack of hard currency reserves will prevent La Paz from lifting the debt moratorium the Siles government imposed last year. In the meantime, the government is depending on sales of gold reserves, exports of an estimated $60 million worth of stockpiled minerals, and international aid. According to the US Embassy, Argentina has also agreed to speed payments for Bolivian natural gas sales, which are currently $40 million in arrears. [redacted] 25X1 25X1 25X1

The initial economic impact of the shock treatment was positive. After a quick spurt in the cost of staple products, prices retreated, resulting in an inflation rate only slightly higher than the average during the two months before the program was announced. Despite removal of price controls, black-market exchange rates have fallen 27 percent to 1.1 million pesos per dollar, roughly equal to the Central Bank auction rate. [redacted] 25X1
[redacted] income from import duties is already 25X1
up substantially. [redacted] 25X1

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Keys To Breaking Hyperinflation

According to a recent academic study, all of the following elements have been required to stop hyperinflation, defined as price rises in excess of 50 percent per month:

- *The introduction of a new currency and a reform of the central bank, with absolute limits on the amount of credit it may grant specified in the constitution or by international agreement.*
- *A reduction in state expenditure and an increase in tax revenue to lower the budget deficit to a level that can be borne by the capital market. Deficits of public enterprises should be eliminated by setting prices to cover costs.*
- *Long-term rescheduling of external debts with a 5- to 8-year grace period on interest and amortization payments and an immediate infusion of foreign credit to cover existing foreign payments problems until tax revenues are revived via fiscal reforms.*
- *Freeing the exchange rate and lifting any exchange controls and import and export restrictions. Excessive customs duties and export subsidies should be gradually rolled back.*
- *The credibility of these measures is typically increased if they are implemented by a new government.*

To date Bolivian price developments parallel a pattern described in this study that indicates that prices tend to stabilize quickly once a comprehensive program is implemented.

The Disparate Domestic Reaction

Competing factions of the powerful Bolivian Workers Central (COB), the largest labor confederation, closed ranks in rejecting the austerity measures. Labor denunciations of Paz Estenssoro's program culminated in a general strike on 3 September. Bracing for more radical protests, Paz Estenssoro declared the strike illegal and threatened to fire striking government workers and to arrest labor leaders. While the COB has received strong support among miners and factory workers, government workers are wavering and the US Embassy reports the strike may be winding down. 25X1

Anticipating these challenges from labor, the President was reportedly careful to solicit support from the military high command before the program was announced. With this key backing, he has placed the Army on alert to support the National Police in containing worker unrest. The armed forces—on direct orders from Paz Estenssoro—have taken control of airports, petroleum processing facilities, electricity plants, and telecommunications installations. 25X1

Opposition leaders have made little public comment since the beginning of the general strike, probably an indication that they are waiting to see whether Paz Estenssoro will be able to sustain his program. Nevertheless, according to US Embassy sources, the initial private reaction of Bolivia's political leaders was generally positive, despite concerns over the impact of the public-sector wage freeze. Officials of the leading conservative party—which holds the greatest number of opposition seats in Congress—give the program high marks. The leading leftist opposition party says the plan may promote economic development, but has called for the Cabinet to submit to Congressional questioning. 25X1

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Uncertain Outlook

Paz Estenssoro's program—a major shift from the statist policies Bolivia has recently pursued—contains essential elements for breaking the inflationary spiral as a first step toward regenerating the economy. Several shortcomings are still apparent, especially the absence of any currency reform or new legislation to limit the government's ability to print money or extend credit. In addition, it is unclear to us whether the new administration has the technical expertise necessary to carry out the complex program.

Although the government is now securing international approval for its program, it still has been unable to arrange new foreign aid or trade credits necessary to bolster its hard currency reserves. Based on Bolivia's lackluster record in sustaining reform, we believe that strict adherence to the austerity package will be necessary to restore international confidence. Until then, the new administration will need to scramble to secure concrete international support to avert a sharp drop in imports.

Paz Estenssoro's reform measures are intended to reinvigorate the private sector, but we doubt that entrepreneurs, long frustrated by government intervention, will develop confidence quickly enough to pick up the slack created by massive public-sector layoffs. Moreover, the revival of the private sector will be dependent on labor cooperation, and this is unlikely without a wage compromise. We believe Paz Estenssoro has room to maneuver on wages, and, in fact, some concessions will result. The Planning Minister has announced that the Cabinet is open to dialogue on the wage issue, the first indication of its willingness to compromise.

We believe Paz Estenssoro's willingness to use the military to quell unrest and the likelihood of continued armed forces backing for the next few months mean he will not back down on the major elements of his program, even though its severity is likely to result in continuing confrontation with radical labor elements. Widespread public sentiment that drastic economic measures are needed is likely to discourage effective, large-scale labor protests as the weakened COB, struggling to save face, moves toward compromise. The President's success in walking the narrow line between firm implementation of austerity and flexibility in gaining domestic acceptance of the program will provide an important indication of whether he has the leadership skills necessary to overcome his weak political base, gain international backing, and continue the consolidation of democratic rule in Bolivia.

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Briefs

Energy

Iranian Oil Company Under Pressure

The National Iranian Oil Company (NIOC) continues to come under attack from the Iranian Parliament (Majles) because of its inability to increase oil revenues. In August, managing director Seyed Kheradmand was fired after defending NIOC oil pricing and sales decisions before the Majles Petroleum Committee [redacted] He is the third senior official to leave NIOC since May. Kheradmand's successor will have similar difficulties because the Majles expects NIOC to increase oil revenues while supporting official OPEC prices, an impossible task in the current soft market. [redacted] 25X1

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Algerian-Brazilian Gas Deal in Doubt

The possibility of Brazil importing 1 billion cubic meters per year of liquefied natural gas (LNG) from Algeria is receding as a result of opposition from the Brazilian state oil company Petrobras. We believe Petrobras fears losing its monopoly position as well as future outlets for its offshore gas discoveries should the July 1985 preliminary agreement between the Sao Paulo state gas company and the Algerian state company, Sonatrach, move forward. To counter the Algerian proposal, Petrobras has increased the amount of gas on offer to Sao Paulo from 280,000 cubic meters per day to 600,000 cubic meters per day beginning in 1987. Despite this setback, we expect Algeria to continue to seek new gas customers beyond its traditional West European buyers. [redacted]

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Turkish-Soviet Gas Deal Stalled

Turkish negotiators returned from Moscow without signing a contract for the purchase of up to 1.5 billion cubic meters (bcm) annually beginning in 1987, projected to rise to 6 bcm in 2000. Disagreement centered on pricing terms. The Turks maintained that the agreement in principle of September 1984 permits complete payment in Turkish goods, but the Soviets insisted on partial payment in hard currency. If the deadlock is broken, Turkey could become dependent on the Soviets for about 95 percent of its natural gas consumption, albeit only about 5 percent of its total energy requirements. Moreover, the gas is initially slated for industry and electrical utilities which could readily switch to alternative fuels. The two sides are to meet again later this month, and Ankara may be forced eventually to drop its insistence on a full barter deal. [redacted] Ankara has decided to solicit international bids for the Turkish section of the pipeline to the USSR because of Soviet foot-dragging in making a proposal. [redacted] 25X1

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Lebanese Fuel Crisis Looms

In an effort to force the Lebanese Cabinet to cut petroleum subsidies, the Ministry of Finance has stopped paying for imported crude and product. The move could result in considerable confusion, gasoline shortages, and rapidly rising fuel prices in the coming weeks. The Director General of the Ministry told the US Embassy that fuel imports are costing the government over $60 million a month and that about 25 percent of the locally produced and imported petroleum products are being reexported to other Mediterranean countries. He commented that the Ministry was prepared to leave petroleum marketing to the black market, if necessary, to get fuel prices to reasonable levels. Some fuel shortages developed last week when fighting and kidnapings in Beirut caused the suspension of petroleum deliveries. Moslem militias have threatened renewed fighting if the situation, which they accuse the Christians of creating, does not get better. If the Finance Ministry's plan works, the Moslem militias may again accuse the Christians of plotting against them and resort to shelling. 25X1

Problems Mounting With Philippine Nuclear Power Plant

Manila is seriously considering mothballing the recently completed $2.1 billion nuclear power plant in Bataan Province, west of Manila. Communist Party front groups are capitalizing on widespread popular opposition to the plant and in June sponsored a general strike against the facility. Furthermore, in recent months Communist insurgents have damaged 28 of the transmission towers leading from the plant. The plant—long plagued by safety concerns, spiraling construction costs, and allegations of a $35 million kickback to a business associate of President Marcos—is unlikely to begin operations in the next several years. The military admits it cannot defend the transmission towers. Mothballing the facility will be costly, however. The plant added over $1.9 billion to the country's foreign debt, costs $275,000 a day in interest payments, and was to be a key element in Manila's strategy to reduce oil imports. 25X1
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Fourth Taiwan Nuclear Power Plant Postponed

Taiwan has decided to postpone the construction of its fourth nuclear power plant. The project launched persistent debate over the extent of Taiwan's future electricity needs and about coal as an energy source. The three existing nuclear plants, one of which was damaged by a fire in July, met 40 percent of the island's demand for electricity last year. The postponement, coupled with the closing of unsafe coal mines, will place a greater burden on electricity production using imported coal, oil, and natural gas. Potential sales of at least $1 billion in US equipment for the nuclear plant over a multiyear period would have helped to narrow the trade deficit with Taiwan—expected to be about $11 billion this year. 25X1

China Power Generation Equipment Imports

Chinese [redacted] negotiated a barter arrangement for the purchase of four 500-megawatt coal-fired generators from the Soviet Union. China will supply wheat, soybeans, and other agricultural products as payment for the generators to be used in two power plants near the Pingshuo coal mine, a Sino-US joint venture. The sale satisfies one of the provisions of the Sino-Soviet long-term economic and technical agreements signed earlier this year, and accounts for one-fifth of China's planned imports of 10,000 MW of thermal power generation equipment during the Seventh Five-Year Plan (1986-1990). The Chinese are also negotiating similar barter/countertrade deals with Czechoslovakian and Romanian suppliers and have expressed interest in such arrangements with US firms. [redacted] 25X1

[redacted] 25X1

International Finance

New Panamanian Financial Pressures

World Bank officials told President Barletta last week that Panama will not receive an expected $60 million structural adjustment loan this year because of insufficient progress on required labor and industrial reforms. Completion of IMF and commercial bank deals, moreover, is tied to World Bank approval. Demonstrations by organized labor against international lending requirements—including one in the Legislative Assembly last week—underscore Barletta's difficulties in securing economic adjustments. If the financial program comes apart, Panama will face further cuts in imports, a deepening recession, and higher unemployment. Public and legislative resistance has stalled Barletta's austerity package for 11 months, and the World Bank's action is likely to fuel nationalist resentment of international financial institutions. Barletta is certain to press his appeal for emergency US aid. His failure to secure the necessary funds—either through reforms or aid—will make him more vulnerable to removal by the military, which looked to him to bring the economy under control. [redacted] 25X1

Yugoslav Agreement on Bank Reschedulings

Yugoslavia has accepted the terms proposed by commercial banks to reschedule payments for debts totaling $3.5 billion that are due in 1985-88. These creditors are offering to reschedule payments over 12 years with a five-and-a-half-year grace period, at an interest rate of 1.125 percentage points over LIBOR. The spread for the reschedulings in 1983 and 1984 is to be reduced by one-quarter and one-eighth percentage points, respectively. Belgrade undoubtedly views the agreement as a victory. After months of protracted negotiations, the banks made several concessions, including lowering interest rates and renegotiating the 1983 and 1984 agreements. Belgrade probably believes the agreement will improve its chances of a multiyear rescheduling from official creditors early next year. [redacted] 25X1

Global and Regional Developments

[redacted] 25X1

EUREKA Joint Venture Threatened

The first joint venture planned under the French-initiated EUREKA program on high-technology cooperation may be in jeopardy [redacted] 25X1 France announced last June that it would finance under EUREKA a project agreed to earlier between France's Matra Group and Norway's Norsk Data to produce high-performance scientific computers. Recently, however, officials of the state-controlled French computer firm, Bull, have complained that the Matra–Norsk Data project is likely to lure French scientists away from their company. Senior Matra officials are now worried that Paris will withdraw support. The French Government has tried to persuade Matra and Norsk Data to include Bull in the project, but Matra—unwilling to lose its competitive edge to a state-owned rival—is resisting. The inability of West European countries to agree on the structure or overall financing of EUREKA has already heightened industry's skepticism of the program, and further French pressure on Matra and Norsk Data could sour their deal completely, giving EUREKA an embarrassing early failure. [redacted] 25X1

Central American Concern Over US Textile Legislation

Threats by the US Congress to restrict textile imports are causing much concern among political leaders and potential foreign investors in the Caribbean and Central America. Specifically, import restrictions could reduce benefits of the CBI Recovery Act's 807 Program that assesses only value-added duty on US goods processed overseas and imported back into the United States. [redacted] Costa Rica fears losing its quota-free status and is preventing Asian firms from using Costa Rica to circumvent US textile quotas. Panama also is worried because Asian countries have been caught using Panama to circumvent US textile quotas. Caribbean and Central American officials argue that including their regions in the proposed legislation would seriously injure the fragile economies of the region. This could lead to political instability and retaliation against US interests, including debt-servicing slowdowns. [redacted]

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National Developments

Developed Countries

Tokyo Restricts Export Insurance for South Africa

Early this month, MITI designated South Africa a "special nation" for export insurance purposes, a move which will increase the cost of insuring exports to South Africa by about 20 percent. The decision also allows MITI to decide whether to provide export guarantees on a case-by-case basis. Many Japanese banks are refusing to provide insurance under the new regulations. Although the bank's reaction will reduce trade somewhat, we believe the effect will be limited because exporters can deal on a cash basis or assume the risk themselves. We believe, however, Tokyo will follow the US lead on trade sanctions because Japan does not want to be seen as undermining US policy. [redacted]

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[redacted]

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Japanese Domestic Demand Measures

In an attempt to dampen US criticism, Tokyo is seeking measures to stimulate domestic demand in ways that would reduce the trade surplus. In a recent meeting with US Embassy officers, a senior official suggested he would welcome US views on such measures. In addition, Prime Minister Nakasone last week ordered that a special study be produced by the end of the month to indicate macroeconomic measures that could have an immediate impact on Japan's bilateral surplus. The timing of these moves reflects widespread Japanese concern over possible US Congressional action this fall. They also probably show Nakasone's desire for concrete progress on the trade front before his planned visit to Washington next month. Disagreement still exists among Japanese officials on many of the measures under consideration, with consensus only on tax incentives for housing investment. Even if agreement can be reached on broader initiatives, however, they are unlikely to have much short-run impact on trade figures and many Japanese officials continue to view export restraints as the only viable alternative. 25X1

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25X1

Canadian Banks Oppose Deregulation

Ottawa's attempt to partially deregulate financial services is being opposed by the Canadian banking community, concerned about its exclusion from the market-freeing proposals. The planned initiatives outlined earlier this summer propose permitting trust, loan, and insurance companies to set up financial holding companies that could offer a full range of financial services. The plan, however, does not include amending the Bank Act, which prohibits banks from offering trust or investment services. As a result, banks would not be able to compete on an even footing with the holding companies. Ottawa, however, is not likely to review the Bank Act any time soon because it fears the six largest chartered banks—which account for more than one-third of private lending—would dominate the financial sector if restrictions on their operations were loosened. In addition, bank deregulation would ease restrictions on foreign—largely US—banking operations, a step likely to provoke opposition by economic nationalists in the Tory and opposition parties. Moreover, the recent collapse of two Canadian banks has further intensified Ottawa's reluctance to loosen controls on the banking industry. 25X1

French Budget Remains Austere

The 1986 draft budget presented by the government last week will not significantly change the budget deficit, and we anticipate it will have a neutral impact on economic growth, which will probably be 2.0 to 2.5 percent in 1986. Government spending in real terms is scheduled to remain flat, thus the share of government in GDP will fall. The Ministry of Industry suffered the largest cutback—a drop in real expenditures of about 20 percent—in response to both the improved financial health of firms and the Socialists' desire to reduce subsidies. The Ministry of Interior's budget was increased by about 18 percent as part of a program to modernize the police. Defense spending will increase only marginally in real terms. On the revenue side, the tax rate on retained earnings will be reduced from 50 to 45 percent, and—as announced earlier—personal income taxes will be cut by 3 percent. Tax brackets were also corrected for bracket creep, a standard French adjustment. 25X1

Australian Unions Triumph in Wage Talks

Prime Minister Hawke's Labor government this month has yielded to trade union demands in semiannual national wage negotiations. Treasurer Keating agreed last week to give union members pay raises equal to the annual rate of consumer price inflation. This reversed earlier promises to trim pay increases to preserve export competitiveness gains since January as the Australian dollar depreciated about 20 percent. In addition, Keating agreed to increase retirement benefits for union workers in July 1986 and cut income taxes beginning in September 1986. Hawke's concessions will ensure industrial peace and boost Labor Party–trade union relations in the near term. Since the plan covers several years, the move also will reassure foreign investors and foreign exchange traders about the stability of the Australian economy. Nevertheless, there will be substantial economic and political costs—increased inflation, a loss of international competitiveness in manufacturing, and a growing perception by businessmen that the unions, rather than the Hawke government, control the economic policy agenda. 25X1

Less Developed Countries

LDC Debtor Growth Estimates

According to current estimates of the major econometric consulting firms, real GDP in the key LDC debtors will grow about 2 percent this year and 3 percent in 1986. Of this group, Brazil and Mexico are expected to perform best, achieving growth of 3 to 5 percent through 1986. The consulting firms anticipate negative growth in Argentina and the Philippines for this year with slight recovery starting in 1986. The other key debtors are expected to grow just 1 to 3 percent during 1985-86. 25X1

Key LDC Debtors: Projected Real GDP Growth, 1985-86

Percent

	1985				1986			
	DRI	Wharton	Chase	Average	DRI	Wharton	Chase	Average
Key debtors				**1.8**				**2.3**
Argentina	−2.7	−5.6	−1.1	−3.1	2.5	1.0	−0.2	1.2
Brazil	3.1	3.5	5.7	4.1	4.0	3.9	3.6	3.8
Chile	1.6	2.2	2.3	2.0	3.6	0.2	3.5	2.4
Mexico	2.9	3.6	3.9	3.4	3.7	3.9	4.9	4.1
Nigeria	−1.9	2.9	0.5	1.7	0.3	3.0	3.0	2.1
Peru	3.7	NA	2.7	3.2	3.0	NA	0.1	1.5
Philippines	−0.9	−1.4	−1.2	−1.1	3.7	0.2	1.0	1.6
Venezuela	2.1	1.8	0.4	1.4	1.7	1.7	1.9	1.7

25X1

Guatemalan Economic Adjustments Put on Hold

Five days of rioting in Guatemala City following the announcement of busfare increases is likely to be used by the Mejia government to justify a hold on economic adjustments prior to presidential elections on 3 November. Chief of State Mejia, according to US Embassy reporting, believes the risk of social unrest outweighs the need for policy reform. The government—in consultation with the IMF—is preparing an economic package to be introduced after the election but before the civilian president takes office in January, according to the Minister of Finance. Although the government and the IMF may reach agreement on the need for a sharp devaluation, deficit reduction measures will be more difficult, given strong private-sector opposition to even modest tax increases. Moreover, Mejia's decision to back down on the busfare hikes and promise public-sector wage increases will make it all the more difficult for a newly elected civilian government to make and sustain unpopular adjustments.

25X1

Barbados' Severe Economic Problems

The Barbadian economy—formerly one of the Caribbean's few strong performers—faces no more than 1-percent growth in real GDP in 1985, following four years of decline. As a result, real output at yearend is likely to remain more than 5 percent below the 1980 peak. According to the Central Bank, the sharp drop in foreign exchange earnings is largely due to continued low world sugar prices, the country's leading export. Manufacturers also are losing sales because of intraregional trade disputes and high wages that have deterred foreign investors. Moreover, the strong US dollar is continuing to hurt tourist receipts as travelers opt for more affordable European vacation spots. To cover the island's financial shortfalls and stem the economic decline, the government has borrowed heavily at home and abroad; external debt increased from $132 million in 1980 to $360 million in early 1985. Meanwhile, unemployment has soared to over 19 percent—a 10-year high—adding to Prime Minister St. John's political woes. Continuing economic difficulties will boost chances for an opposition victory in the next national elections, constitutionally due by March 1986. [redacted] 25X1

Nigeria Seeking Western Assistance

President Babangida plans to send a delegation to the United States and other Western nations to request economic assistance and explain Nigeria's willingness to cooperate with the IMF [redacted] Babangida told the US Embassy that he plans to hold a national debate on the IMF issue to gain support for an agreement. [redacted] 25X1 25X1

Western receptiveness to Nigerian overtures will influence the regime's willingness to implement reforms recommended by the IMF. The previous government's excessive anti-IMF rhetoric probably has inclined Babangida to calculate that he must gain some tangible economic benefits—such as immediate access to new long-term credits—if he is to win public acceptance for a Fund agreement. [redacted] 25X1

More Moroccan Austerity

Morocco unexpectedly increased prices for most basic foodstuffs by 11 to 40 percent last week to set the stage for IMF negotiations and Paris Club debt rescheduling, according to the US Embassy. This should improve Rabat's bargaining position with both the IMF and Paris Club creditors during talks beginning this week. Government officials have put security forces on alert to limit chances for public unrest like the food price riots of January 1984. Nevertheless, disturbances are possible if opposition political parties and various trade unions can formulate coordinated responses. Moreover, Morocco's youth return to school soon, heightening prospects for disturbances. [redacted] 25X1

Kuwait To Cut Foreign Aid

Kuwait will cut its proposed foreign assistance programs by 40 percent to $900 million, according to Foreign Minister Sabah al-Ahmed. The Kuwait Fund—which distributes all except emergency aid—will reduce grants but will continue to make loans to countries that support the Kuwaiti positions on international issues. The government decision to cut foreign aid probably was prompted by falling oil revenues—down by half since 1979. Cuts which would seriously affect key Arab aid recipients—Jordan, Syria, and the PLO—are unlikely because of Kuwaiti fear of terrorist reprisals. Kuwait, however, may reduce oil aid to Iraq once revenues from the Saudi-Iraqi spurline begin to flow later this fall. [redacted] 25X1

Communist

Soviet Ministerial Consolidation

A Soviet official has told US Embassy sources that General Secretary Gorbachev is planning to combine three entire agricultural ministries and portions of two others into a single "super ministry." The new organization, said to be similar to those currently existing in the republics of Georgia and Estonia, reportedly may be established by year's end. Gorbachev hinted at such a reorganization in a speech in June and indicated that it would serve as a model for the other economic sectors. A reorganization of the sort described would help to overcome some of the bureaucratic infighting and lack of coordination that have hampered the agricultural and other sectors of the economy. Like past attempts to streamline the increasingly cumbersome ministerial structure, however, the reorganization almost certainly would provoke fierce resistance from the bureaucrats affected. Gorbachev's apparent determination to proceed reflects confidence that he enjoys sufficient political momentum to push it through. 25X1

Surge in China's Money Supply

China's money supply grew 50 percent in 1984, according to belatedly released official statistics, with 80 percent of the increase in the fourth quarter. The increase has caused China's official inflation rate to more than double so far this year and lies behind many of Beijing's other recent economic problems, including excessive industrial growth, runaway capital construction, and skyrocketing imports. The money supply increase occurred because of reforms that granted local banks more autonomy to approve loans without proper guidelines or a mechanism to ensure repayment. The accidental leak of a government decision to base 1985 credit allocations on 1984 loan totals added to the fourth-quarter surge. Since March, Beijing has raised interest rates, set tight credit limits for banks, and increased sales from state-run stores to soak up excess cash. Credit tightening has not yet slowed China's rapid industrial growth or dampened consumer spending, but it apparently has created credit shortages in some rural areas. 25X1

The money supply statistics—with their implications of financial mismanagement and bungled reform policies—are politically damaging to Deng Xiaoping's reform coalition on the eve of the party conference. Chinese officials are now pressured by the need to restrain credit to combat inflation, while ensuring that rural areas have adequate funds to purchase the fall harvest. Recent press reports, however, suggest Beijing remains committed to continuing its tight-money policy. 25X1